Tax-Free Childcare: childcare account provision

A short proposal for HM Treasury and HM Revenue and Customs

Background

In August 2013, HM Treasury (HMT) and HM Revenue and Customs (HMRC) consulted on the design and operation of a new Tax-Free Childcare scheme. In its March 2014 response to the consultation, Government took the view that there would be significant advantages associated with delivering Tax-Free Childcare itself using NS&I as delivery partner, including simplicity and cost-savings.

On May 23rd, Government issued a further consultation ("the consultation") seeking views on four options for delivering Tax-Free Childcare accounts, summarised on page 7 of the consultation:

» ***Government provider*** – either through NS&I using its existing banking infrastructure and service capabilities, or within HMRC;

» ***Single provider*** **–** the Government would tender for a single, private sector provider of childcare accounts;

» ***Small, fixed number of contracts*** **–** the Government would tender a small, fixed number of contracts for entities to become account providers; and

» ***Open market*** **–** account providers would enter into arrangements with HMRC through a framework procurement, so that account fees are paid by Government and not parents.

Importantly, there are two key changes in relation to the above options and those considered in our first report for HMT and HMRC. Firstly, our previous analysis evaluated different "private sector" models of account provision. We did not, therefore, consider the first option above – Government provision. Secondly, Government has now made a commitment that parents will not pay fees to childcare account providers under any model – whereas in our previous analysis, this was considered only as a possibility.

Given the above changes, HMT and HMRC have asked Economic Insight to consider what analysis and work could be undertaken in order to provide an updated assessment of the latest range of options now under consideration. This short proposal therefore addresses our proposed approach and deliverables in this regard.

Suggested scope of work

The scope of our proposed work will be to provide HMT and HMRC with an assessment of the likely pros and cons of the four childcare account provider options outlined in the latest consultation, from an economics perspective. The overall framework we propose to use will be the same as that in our original report. That is to say, we will consider the both the demand and supply side economics issues associated with each option, and relatedly, the likely benefits and risks associated with these.

Given that we consider it unlikely that any material new evidence will be available to us over and above that relied upon in our first report, clearly our directional findings regarding the relative merits of there being more, or less, competition across the alternatives are unlikely to change. Therefore, our approach will be to start from the evidence and our assessment of that evidence as contained in our prior report, and consider its relevance to the latest set of options. Within this general approach, we think that it would be appropriate to focus our efforts on considering the implications of the two key changes noted above:

- that there is now a new in-house model of provision under consideration – which was not within the scope of our prior work for HMT and HMRC – so we must develop evidence and analysis relating to this in any new report; and
- that the commitment to parents not paying fees means that our previous assessment of the likely effectiveness of competition under the open market model should, to a degree, be reconsidered.

Therefore, whilst we will provide HMT and HMRC with a report that summarises the likely economics pros and cons of all four options, our efforts will be focused more on understanding the above two issues, rather than revisiting in detail the question of “how many” suppliers is most likely to be optimal from the perspective of parents and other stakeholders. In our view, this represents a pragmatic approach to meeting the requirements and prioritises the development of evidence around the factors that have evolved since the prior consultation.

We further recognise that, in practice, the above options are part of a broad spectrum of available choices – and that there are many subtle nuances with respect to how any one option could be applied in practice. Therefore, we intend to provide HMT and HMRC with our assessment of the likely benefits and costs of each, contingent on what one believes about the likely market characteristics.

As our general approach for evaluating the broader set of four options is set out in detail within our previous report, in the following we briefly summarise the work and analysis we propose to undertake in order to inform our evaluation of: (i) the pros and cons of in-house versus outsourcing models (which will be used to inform our evaluation of the new option, relating to provision via NS&I); and (ii) the Government’s commitment to parents not paying fees directly to childcare account providers and the implications of this for any evaluation of open market type models.

Our approach to completing the work

As noted above, we focus here on explaining what analysis and work we would undertake in relation to (i) assessing in house versus outsourcing models; and (ii) assessing the impact of Government paying fees on the open market model.

Assessing in house versus outsourcing models

Economic framework and theory

There is a rich economic theory and literature on the costs and benefits of in-house versus out-sourced provision and it relates closely to the theory of the firm.[1] We propose to use this theory and literature to help create the framework for our analysis and develop arguments for and against the different models. At the highest level, economic theory suggests that in-house provision could be beneficial when the ***transaction costs*** of going to market are high and/or where going to market would involve high risks due to the scope for ***opportunistic behaviour***.

The transaction costs of going to market could include those associated with: designing and running competitions; and ensuring compliance with regulatory / service requirements – i.e. writing rules, monitoring and enforcement. All of these transaction costs could be incurred more than once.

The risks associated with going to market typically arise due to two reasons: ***information asymmetries*** and ***asset specificity***.

» Information asymmetry problems arise when it is difficult for Government to objectively measure and evaluate the performance of account providers, and so difficult to ensure that they are meeting the terms of their contract and are providing "value for money". This is most likely to occur in the supply of "complex services", where it is hard to define (and so contract for) what constitutes "good performance" and/or where it is hard to distinguish between performance failures motivated by opportunistic / rent-seeking behaviour versus circumstances outside of the control of suppliers.

» The asset specificity problem arises when either or both of the Government and suppliers have to make significant and sunk investments to trade and where those investments would have little value outside of the provision of tax free childcare accounts. Making such investments could expose one or both parties to the future risk of "hold-up" by the other – i.e. an attempt to expropriate value through renegotiating contracts knowing that the other party has little option but to accept revised terms.

We envisage focusing our analysis on the transaction costs of going to market and the potential for information asymmetry problems. The asset specificity problem seems to be of less relevance here for two reasons: (a) the analysis set out in our previous report suggests that the sunk investments required to supply childcare accounts are, relatively speaking, modest; and (b) at least to some extent, the necessary investments have already been made by Government and suppliers.

Developing evidence and analysis

As in the case of our first report, we envisage using a combination of qualitative and quantitative analysis to help evaluate the options.

The qualitative analysis would involve developing the arguments set out above based on the available information about the different options and the economic literature. In particular, we envisage our assessment of the "information asymmetry" problem being largely qualitative and supported by relevant facts. For example, we would seek to understand:

- first, the extent to which performance could be hard to observe or measure, with reference to the characteristics of the service (both HMRC and parent-facing service dimensions) and possible comparators (e.g. the provision of other benefit-related transaction services); and
- second, the extent to which an arrangement with NS&I could mitigate the information asymmetry problem e.g. what governance arrangements are in place with NS&I, how much operational input do HMT and HMRC have in relation to NS&I's activities now?

Our quantitative analysis would be largely focused on sizing the transactions costs outlined above. We envisage drawing on a range of publically available information to put a credible range to these costs. For example:

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[1] *A seminal reference is Williamson, O (1985), "The Economic Institutions of Capitalism", Free Press.*

- ***Designing and running competitions.*** We will seek to estimate this using "bottom-up" and "top-down" approaches. A "bottom-up" approach would involve estimating how much time different members of staff would spend on designing and running a competition (including the costs associated with suppliers participating in them) and multiplying these figures by their salaries (pro-rated). We would combine this view with publically available information on the cost of procurement to arrive at an estimate.

- ***Ensuring compliance with regulatory / service requirements.*** A number of other departments and regulators have estimated the costs for Government and market participants associated with regulation / service requirements, which we envisage using to help size these costs. For example, Defra has estimated the costs associated with monitoring the competitive market for the supply of water and wastewater services to non-household customers. Also, BIS has estimated the cost of monitoring and enforcing compliance with competition law.

Obviously, some of the sectors used in our analysis will be better comparators than others, and so we would seek to identify criteria that would help determine how much weight should be attached to them, as part of the work.

Assessing the impact of Government paying fees on the open market model

Economic framework and theory

With respect to the likely extent of competitive rivalry between firms under an open market model (and the related benefits such competition might bring) the presence of absence of a visible market price to consumers (parents) has ambiguous effects. This will depend on:

- The relative importance of "price / cost" to parents when making purchase decisions – and therefore how critical price is as a driver of switching and choice.

- How comparable price is across suppliers – that is to say the price of some products / services is inherently easier to compare than for others. Consequently, even if price matters to parents, its effect on competition between suppliers also rests on the transparency of price.

- The extent of any search costs associated with parents making comparisons – particularly in relation to price. That is to say, even if the "measure" of price is understandable (as per the point raised above) there is an issue of how "visible" that price is across suppliers. This will also impact comparability of price and the extent to which it could affect choice and switching.

- The extent to which competition could develop around non-price factors. Irrespective of how important, comparable, and transparent pricing factors are to parents, it is also essential to consider ether other factors (such as service quality) could vary across childcare account suppliers and whether this might be sufficient to drive choice and switching under an open market model.

The above issues were considered within our original report, but given the policy commitment to zero fees, it is now important that we consider the above in more detail.

As part of our work, we would also consider how a restriction on a supplier's pricing model, could affect the scope for competition more generally – i.e. the business models that suppliers might be obliged to adopt and so the scope for service differentiation and consumer choice.

Proposed analysis and evidence

Each of the key issues outlined above are difficult to determine with any precision in relation to a nascent market, such as the proposed new market for childcare account provision. This is because, for example, there is by definition no historical switching data, that can be used to analytically determine whether "price" is more or less important than "quality" as a driver of choice. Consequently, our proposed work in relation to this issue will be primarily qualitative in nature.

To inform our assessment of the issues identified above, our approach will consist of drawing conclusions from the evidence in our previous report and supplementing it with:

- A review of the relevant academic economics literature, to determine the key factors that determine the likely impact of any individual factor. For example, identifying what specific features most determine whether prices are likely to be transparent and comparable?

- A stylised analysis of what the likely "extent" of any price might be (were prices to be visible and paid by parents) so that we can establish a potential counterfactual to evaluate the latest proposals against. For example, it could be that, the "smaller" the childcare account price component is, relative to the cost of childcare itself, the less important it is likely to be in any case with respect to driving switching (in which case the absence of a transparent price may not matter).

- First principles economic reasoning, potentially with reference to market outcomes in regulated sectors, to help develop a view on how Government set prices could influence business models, competition and market outcomes. For example, under this model, Government will set a price to pay to suppliers. In doing so, Government will need to specify the level / type of service it expects suppliers to offer at that price and so will, to some extent, influence: the attractiveness of the market, the business models suppliers adopt, the amount of commercial freedom they do have or perceive they have and so on.

Ultimately, we will bring the above together to provide a qualitative "scoring" of the key issues specifically in relation to tax-free childcare accounts – and then from this, set out the implications for our assessment of the relative pros and cons of an open market model, relative to that provided in our original report.

Further information

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